

SWITZERLAND

Securities Lending and Repo Transactions: New Tax Regulations

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1. INTRODUCTION

Swiss tax law does not contain any specific provisions dealing with securities lending and borrowing (SLB) or repurchase (repo) transactions. The tax rules dealing with such transactions were exclusively developed by the tax authorities (in particular, the Federal Tax Administration, FTA) in conjunction with industry specialists from the Swiss Bankers Association (SBA). SLB and repo tax rules were first published in 1990 by SBA Circular 6910 of 29 December 1998, FTA Notice S-02.140 issued in December 1998 and SBA Circular 6586 of 29 May 1990, which were later amended by SBA Circular 1456D of 12 August 1999. In the meantime, a number of tax issues have gathered increasing practical importance, including:

- “unjustified” claims for relief from Swiss federal and foreign withholding taxes (WHT);
- “improper” use of income tax benefits;
- legal status of parties involved;
- beneficial ownership of the proceeds arising from the transactions; and
- legal classification and certification of compensation payments.

The FTA and the SBA formed a working group with a view of coming up with solutions for the above-mentioned tax issues. The working group reviewed those matters and issued recommendations, based on which the FTA on 1 September 2006 published its new Circular 13 regarding Swiss WHT, foreign WHT relief, Swiss federal stamp duty and Swiss federal income tax issues in connection with SLB and repo transactions.

The rules of the new Circular 13 became immediately effective upon publication, subject to a transitional period until 1 January 2007. Also, on 1 September 2006, the SBA published its Circular 7481 with supplementary information. The new Circulars are aimed at avoiding the improper use of tax benefits and the multiple application of relief from Swiss and foreign WHT and other tax relief in connection with SLB and repo transactions. They do not apply to economically similar transactions such as swap transactions, collateralization or securities, which also involve an on-payment of investment income that may suffer a WHT. Circular 13 indicates that the general WHT principles regarding beneficial ownership are applicable to such transactions.

The new rules primarily address SLB transactions and are applicable to repo transactions by analogy. SLB and repo transactions involve a transfer of legal ownership. An SLB transaction is not a sale agreement, but the borrower acquires legal and beneficial ownership of the securities lent. The borrower is only required to

repay the lender with equivalent securities, i.e. of the same kind and amount (fungibility). From an economic perspective, the borrower borrows securities, pays a lending fee, pays compensation of an amount equal to the original dividend or interest, and may provide cash (or security) collateral. The lender pays interest on the cash collateral.

In legal terms, a repo is a spot sale and a forward purchase by the original owner. The interim holder acquires legal and beneficial ownership during the term of the repo. The interim holder’s obligation is to sell back securities of same kind and amount (fungibility) on the forward leg. From an economic perspective, the original owner borrows money, pays interest and provides securities collateral, where the interim holder provides the cash loan and pays compensation of an amount equal to the original dividend or interest. The price differential between the sales price and the repurchase price is the cost to the original owner for using cash (repo rate).

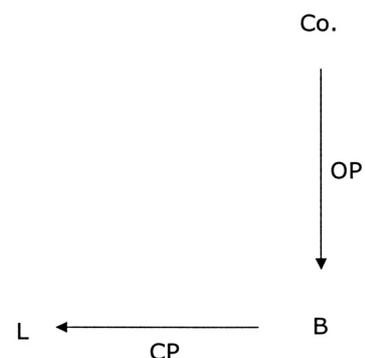
The new Circulars address three base cases,² namely long borrowing transactions, chain transactions, and resale transactions.

2. STANDARD SECURITIES LENDING AND BORROWING TRANSACTIONS

2.1. Long borrowing

This scenario involves a transaction whereby the borrower of securities does not on-lend or resell the borrowed securities. The borrower (B) pays on the original dividend or interest (passed-on payment) to the lender (L).

Figure 1: Long borrowing transaction



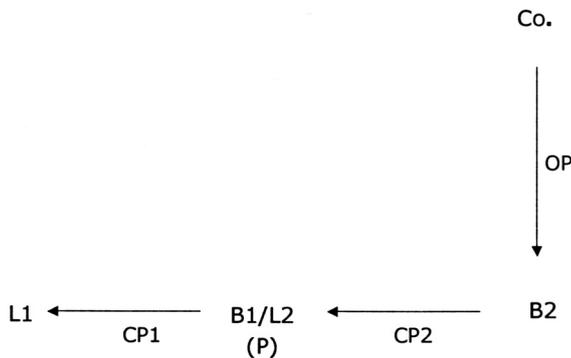
1. Bär & Karrer, Zurich.

2. The following diagrams are based on those of Fritz Muller, Credit Suisse, delivered at the Tax Conference of the Swiss Bankers Association on 15 March 2006, Zurich.

2.2. Chain transactions

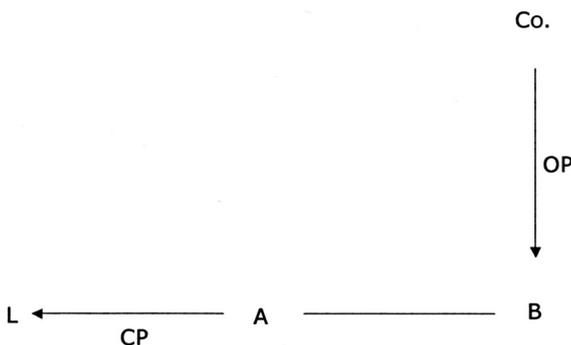
The term “chain transactions” describes a series of SLB transactions involving an intermediary that acts as a principal (P) between the primary lender and the ultimate borrower of securities.

Figure 2: Chain transaction – principal structure



Such chain transactions must be distinguished from SLB transactions over several stages in which the intermediary acts only as an agent (A) between the primary lender and the ultimate borrower, whereby the parties are disclosed.

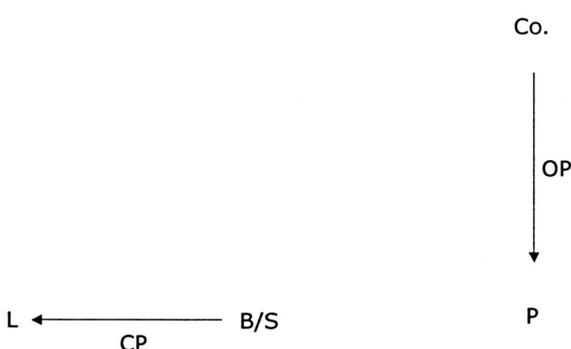
Figure 3: Chain transaction – agent structure



2.3. Resale transactions

The borrower of securities sells the securities on to another person. The borrower and seller (S) respectively do not receive the original dividend or interest and, thus, pays a manufactured amount the lender (L). The purchaser (P) receives the original dividend or interest.

Figure 4: Resale transaction



3. ORIGINAL PAYMENTS AND COMPENSATION PAYMENTS

SLB and repo transactions are often entered into over a dividend or interest coupon payment date. The lender or repurchaser of the securities thereby misses the original payment of a dividend or interest coupon on the underlying securities and is usually compensated by the borrower or reseller with a compensation payment (CP) of dividend or interest in lieu of the original payment (OP). Resident original payers of dividend or bond interest, or their Swiss paying agents (normally Swiss banks) in lieu of the original payers, generally are obliged under the Federal Withholding Tax Act of 13 October 1965 (WHT Act) to withhold 35% tax at source from the gross payment and to remit such tax to the FTA within 30 days of the payment or due date of the relevant dividend or interest.³ In addition, the debtor of the taxable payment (or the paying agent representing the debtor) must issue a WHT voucher to the recipient, specifying the gross amount of the taxable payment and the 35% tax deducted.⁴ The tax voucher enables the recipient, or actually the beneficial owner of the payment, to subsequently claim appropriate relief from WHT (through full or partial refund, or through credit against the income tax liability of a resident individual, as the case may be) under the WHT Act or any applicable income tax treaty.⁵

Especially in SLB transactions involving a non-resident borrower and a Swiss bank as intermediary in a chain of transactions, the Swiss bank is generally unable to identify whether the payment it is receiving from the non-resident borrower is in fact a passed-on payment of dividend or interest, or rather a manufactured payment. The Circulars consider only compensation payments and, thus, do not distinguish between passed-on payments and manufactured payments. Thus far, the tax voucher system also has not drawn any distinction between original payments and compensation payments. As a result, the Swiss bank intermediary would generally issue a “normal” tax voucher to its customer for the payment it has received from the borrower of the securities, thereby enabling the customer to use the tax voucher as underlying documentation for the reclaiming of Swiss federal or foreign WHT, regardless of whether the payment received is actually a passed-on payment that has suffered WHT, or merely a manufactured payment which may not have been subject to any WHT at all.

The new Circulars fundamentally change the WHT voucher system, as far as such vouchers are issued by resident persons. Resident issuers of WHT vouchers will now be required to report compensation payments (*Ausgleichszahlungen*) as such, in order to prevent those vouchers from being used by the recipients as documentation supporting the reclaiming of WHT and/or an income tax relief, as the case may be. In the past, the non-distinction between passed-on payments and manufactured payments often led to the multiple WHT reclaims for the same payment of dividend or interest, which was effectively subject to WHT only once.

3. Art. 4(1)(a) and (b) and Art. 10(1) WHT Act.
 4. Id., Art. 14(2).
 5. Id., Art. 21(1).

4. SECURITIES LENDING AND BORROWING WITH SWISS SECURITIES

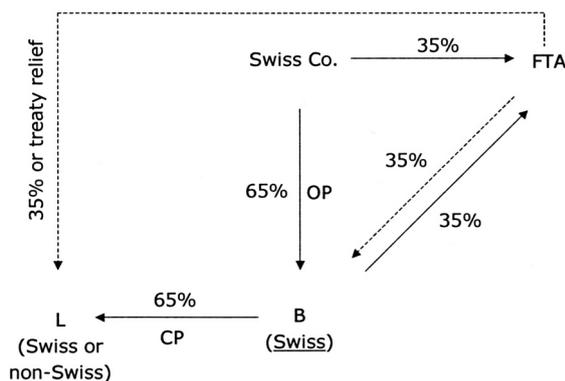
4.1. Swiss borrower

4.1.1. Long borrowing

The new Circulars establish a system of dual Swiss WHT and dual tax reclaim possibility for all long borrowing transactions in securities the income on which is subject to WHT, when the borrower is a resident party. In fact, that dual system already existed for Swiss banks; the scope of the system has now been extended to all resident (long) borrowers. Accordingly, not only the Swiss issuer (or its paying agent) of the underlying security must withhold 35% tax and issue a WHT voucher in respect of the original payment of dividend or interest, but in addition the resident borrower of such securities again must withhold 35% federal tax (the “secondary” WHT) from the compensation payment, which is calculated based on the original taxable payment. The resident borrower will issue a similar WHT voucher to the lender, which will enable the lender to reclaim the secondary WHT from the FTA under the applicable domestic law or applicable treaty provisions. The resident borrower is entitled to set-off its secondary WHT obligation (the federal WHT system technically defines the debtor of a taxable payment as the WHT subject, liable for the tax to the FTA) against its refund claim for the federal tax withheld from the original payment of dividend or interest. On the other hand, the lender may reclaim the secondary WHT on the compensation payment under domestic law or applicable treaty provisions and the rules pertaining to the original payment (in a treaty context, the dividend or interest articles, as the case may be).

The extension of the dual WHT payment and reclaim system to all resident borrowers is in particular designed to prevent owners of Swiss equity or debt securities from effectively escaping the Swiss WHT burden by lending the securities to a Swiss non-bank borrower, which under the previous rules could obtain full WHT relief in respect of the original payment, without being obliged to apply any (secondary) WHT to the compensation payment made to the securities lender. However, Swiss law still cannot oblige non-resident borrowers of Swiss securities to impose such a “secondary” WHT on the compensation payment to the lender, even if the foreign borrower may be entitled to a treaty-based (partial) Swiss WHT relief in respect of the original payment. See Figure 5.

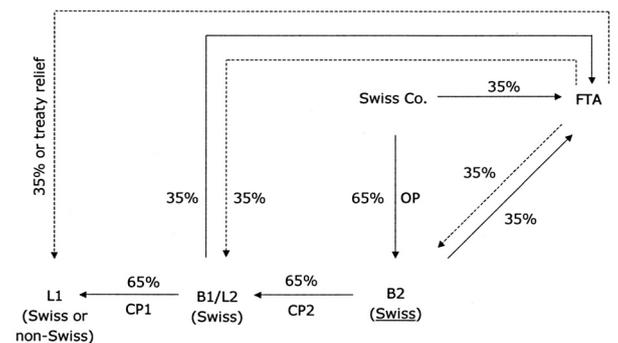
Figure 5: Long borrowing – Swiss borrower



4.1.2. Chain transactions

The above-mentioned principle also applies to a resident borrower of Swiss securities in a chain transaction, whereby the resident borrower on-lends the securities to a further borrower. Regardless of the amount of the compensation payment received by the resident borrower from the secondary borrower, the resident borrower must apply the secondary Swiss WHT to the compensation payment it is making to the primary lender, calculated on the amount of the original taxable payment of dividend or interest. If the second borrower is also a resident person, the Swiss primary borrower’s application of the secondary WHT on the compensation paid to the primary lender is a condition precedent for the WHT reclaim regarding the (net of tax) compensation received from the secondary resident borrower. The primary borrower is entitled to set-off its obligation to pay the secondary WHT on the compensation to the primary lender against the tax reclaim regarding the (net) compensation received from the secondary borrower. The primary lender may reclaim Swiss tax withheld from the compensation payment received under domestic law or applicable treaty provisions. See Figure 6.

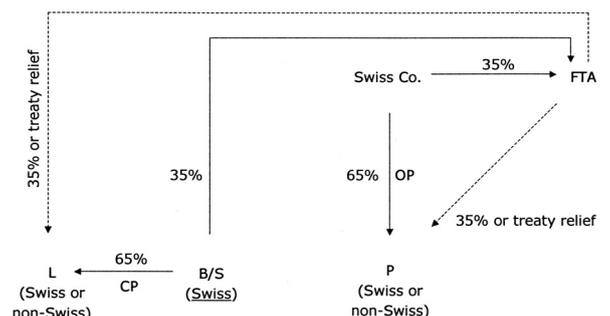
Figure 6: Chain transaction – Swiss borrower



4.2. Resale transactions

Even when the resident borrower sells the borrowed Swiss securities to another party (in fulfilment of a delivery obligation or otherwise), it must apply secondary WHT to the compensation payment made to the lender, calculated based on the original payment of dividend or interest. The lender may be entitled to tax reclaim under domestic law or applicable treaty provisions. See Figure 7.

Figure 7: Resale transaction – Swiss borrower

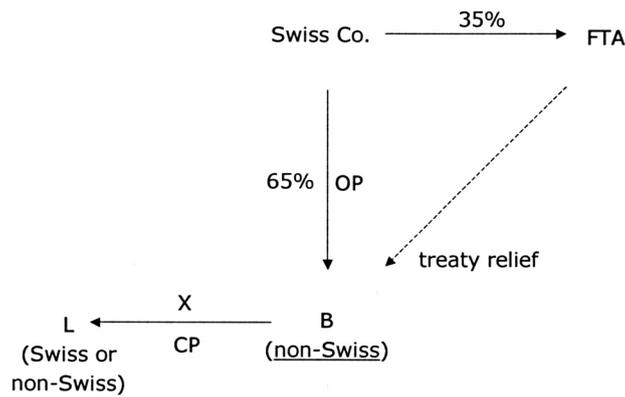


4.3. Non-Swiss borrower

4.3.1. Long borrowing

Non-resident (long) borrowers may be entitled to WHT reclaim in respect of the original payment under an applicable income tax treaty, usually under the provisions governing the original payment. The non-resident borrower is treated as the beneficial owner under general treaty rules. Furthermore, the non-resident borrower is not obliged to withhold a “secondary” Swiss WHT. See Figure 8.

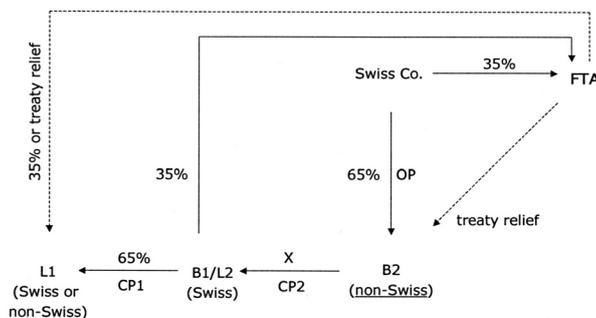
Figure 8: Long borrowing – non-Swiss borrower



4.3.2. Chain transaction

In Figure 9 the primary borrower will request a 100% compensation payment because of its “secondary” WHT obligation. The secondary borrower is treated as the beneficial owner under general treaty rules.

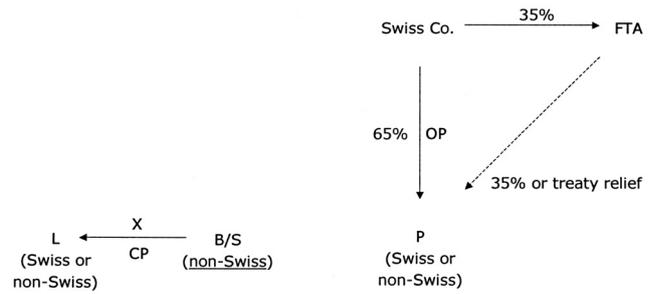
Figure 9: Chain transaction – non-Swiss borrower



4.3.3. Resale transaction

In the case of SLB transactions between non-resident parties, as is shown in Figure 10, the lender may reclaim confirmed Swiss tax withheld from the compensation payment received only if it can demonstrate that Swiss WHT has been effectively deducted from the compensation payment and remitted to the FTA.

Figure 10: Resale transaction – non-Swiss borrower



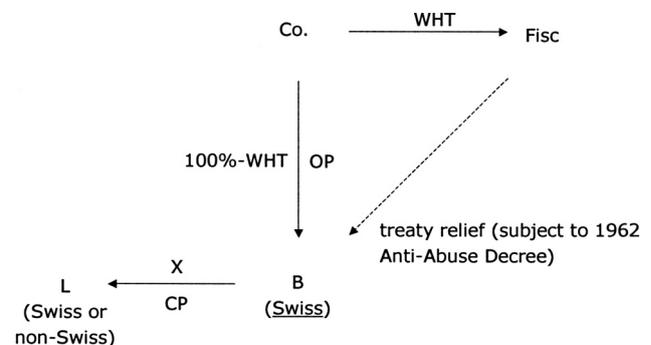
5. SECURITIES LENDING AND BORROWING WITH NON-SWISS SECURITIES

5.1. Long borrowing

A resident borrower of foreign securities that receives an original payment of dividend or interest is generally regarded as the beneficial owner of such payment under general treaty rules. Accordingly, the resident borrower may in principle claim treaty-based relief from foreign WHT in its own right, unless the applicable treaty or domestic law of the issuer stipulates anything to the contrary. The resident borrower’s entitlement to treaty-based relief from foreign WHT is, however, subject to Swiss unilateral anti-treaty-shopping measures pursuant to the relevant Swiss Federal Decree of 14 December 1962 (1962 Anti-Abuse Decree) and FTA guidance issued thereunder.⁶

The resident borrower will generally have to make a compensation payment to the lender, the amount of which may be freely agreed between the parties – the compensation may or may not include a foreign WHT on the original payment, or any relief for such tax. The resident borrower now must issue a confirmation statement to the lender which clearly discloses the fact that the lender is receiving a compensation payment, not an original payment, and which indicates the underlying original payment. However, the confirmation statement must not reflect any non-Swiss WHT, in order to prevent it from being used as a (foreign) WHT reclaim voucher. See Figure 11.

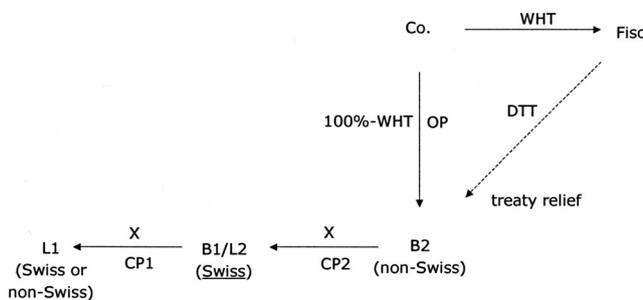
Figure 11: Long borrowing transaction



5.2. Chain transactions

One of the more significant restrictions compared to the previous Circulars concerns chain transactions in foreign securities involving a resident borrower. According to the practice thus far, the customer acting as lender of foreign securities generally received a compensation payment and a voucher from the Swiss borrower bank, both of which therefore corresponded to the original payment and the tax voucher. However, under new Circular 13, while the Swiss borrower bank and the lender of foreign securities may freely agree upon the amount of the compensation payment to be made to the lender, the resident borrower (bank) will be barred from issuing the confirmation statement for the compensation payment in the form of a (foreign) tax reclaim voucher. The confirmation statement must clarify the nature of the payment as a compensation payment (rather than an original payment of dividend or interest) and indicate the underlying original payment; no foreign WHT may be reflected on the confirmation statement. In the event that the foreign secondary borrower must deduct foreign WHT from the secondary compensation payment made to the resident borrower, the latter may be entitled to request treaty-based refunds of such foreign WHT under the rules described in 5.1., as if it had received an original payment. Thus, the 1962 Anti-Abuse Decree is not applicable to the original payment and to the secondary payment only where the foreign secondary borrower is obliged to deduct foreign WHT from the secondary compensation payment. See Figure 12.

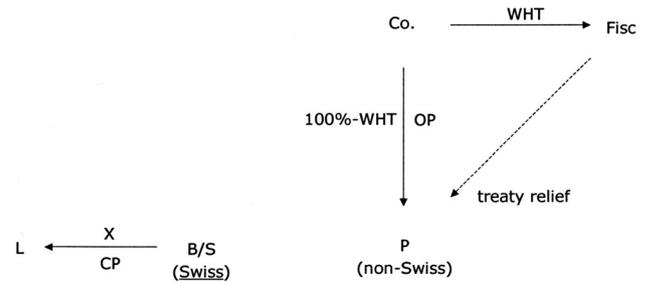
Figure 12: Chain transaction



5.3. Resale transactions

A resident borrower of foreign securities may use the securities for delivery to a third party under a resale, or in fulfilment of an existing delivery obligation towards such third party. The resident borrower generally must make a compensation payment to the primary lender for the foregone original dividend or interest. The amount of the compensation may be freely agreed upon. However, the confirmation statement issued by the resident borrower must clarify the nature of a compensation payment (as opposed to an original payment of dividend or interest) and indicate the underlying original payment, and must not reflect any foreign WHT. Again, this new rule is designed to prevent the primary lender from using the confirmation statement of the resident borrower as a foreign tax reclaim voucher. See Figure 13.

Figure 13: Resale transaction



6. CASH COLLATERAL AND REPO RATE

Interest paid on SLB cash collaterals and repo rates paid by Swiss banks in the meaning of the WHT Act⁷ as cash-takers are, in principle, classified as interest from Swiss bank deposits and are thus subject to 35% Swiss WHT,⁸ unless the beneficiary of the payment qualifies as a recognized Swiss or foreign bank (inter-bank exception).⁹

7. CORPORATE INCOME TAX

Original payments (interest, dividends) are classified as taxable income at the level of the resident borrower. The resident borrower is entitled to participation relief in respect of the original dividend, if the requisite conditions are met.¹⁰

Compensation payments are classified as taxable income at the level of the resident lender and as business expenses at the level of the resident borrower. The resident lender is not entitled to participation relief on the compensated dividend.

Lending fees are classified as taxable income at the level of the resident lender and as business expenses at the level of the resident borrower.

8. INDIVIDUAL INCOME TAX

Resident individuals must include original payments of dividend and interest, compensation payments and lending fees in their taxable income. Compensation payments and payments of lending fees made by individuals are generally tax deductible, if those payments concern the individual's business property (*Geschäftsvermögen*). If the transactions are entered into for the private property of individuals (*Privatvermögen*), lending fees and compensation payments are not deductible in the resale scenario.

6. Federal Decree of 14 December 1962 on measures against the improper use of tax treaties concluded by Switzerland; FTA Circular of 31 December 1962 and FTA Circular of 17 December 1998 (as amended in 2001). See Peter Reinartz, "Revised Swiss Anti-Treaty Shopping Rules", 53 *Bulletin for International Fiscal Documentation* 3 (1999), at 116-117.

7. For purposes of Swiss WHT liability in respect of interest paid on Swiss bank deposits, Swiss banks include the banks and savings institutions regulated under the Federal Banking Act, as well as any other resident party

9. FEDERAL TRANSFER STAMP DUTY

SLB and repo transactions are not subject to federal stamp duty on the transfer (turnover) of securities.

10. CONCLUSION

Even the new Circular 13 cannot impose any particular obligations on non-resident borrowers or repo counterparties of Swiss or foreign securities. Thus, a resident or non-resident owner of Swiss or foreign securities may still be able to effectively escape applicable Swiss or foreign WHT on dividends or interest paid in respect of such securities by entering into an SLB or repo transaction over the payment date with a non-resident borrower or repo counterparty, depending on the reporting obligations and anti-abuse measures applicable to the foreign counterparty under foreign law.

Thus far, in an SLB or repo transaction involving Swiss equity or bond securities, Swiss tax law would generally recognize the foreign borrower or repo counter-

party as the beneficial owner of the original payment of dividend or interest made by the issuer. However, in particular in connection with transactions between or involving affiliated parties, it must be borne in mind that the FTA generally makes the recognition of a legal entity incorporated abroad as a beneficial owner for purposes of treaty-based WHT relief subject to the existence of sufficient business substance of the foreign party in its country of residence.

Moreover, the new Circular 13 is not applicable to swaps and other transactions with economic effects similar to an SLB or repo transaction. Thus far, to the authors' knowledge it has not been tested, whether a recipient of an original payment of dividend or bond interest that has suffered Swiss WHT – including a borrower or repo counterparty in respect of such Swiss securities – which has entered into a swap or similar transaction with yet another party in respect of such original payment can still be regarded as the beneficial owner for purposes of making the reclaim of Swiss federal tax withheld from the original payment.

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